Principal Asset Management℠

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Bring on the acronyms: What regulators should consider to end the “confidence of crisis”

Since the Federal Deposit Insurance Corporation (FDIC) took First Republic Bank into receivership and subsequently sold it to J.P. Morgan, U.S. regional bank stocks have tumbled— with select banks down over 30%. Despite swift public and private sector intervention, the measures taken to quell the “crisis of confidence” since March have apparently failed to the point where far more drastic measures are needed. Put simply, it’s time for U.S. regulators to dust off their Global Financial Crisis (GFC) playbooks and consider putting a couple of retired acronyms back to work.

TLGP: Temporary Liquidity Guarantee Program

The TLGP had two very useful components: (1) the Transaction Account Guarantee Program (TAGP) and (2) the Debt Guarantee Program (DGP). The TAGP was a guarantee of all noninterest-bearing transaction accounts (e.g., large deposits that could seek a shift to the safe haven “Big Six” banks). The goal of this program was to keep funding from fleeing banks. The DGP, on the other hand, essentially allowed banks to issue senior unsecured debt that the FDIC guaranteed. The goal of this program was to ensure banks could access funding and enable banks to rollover their short-term funding during a period of heightened uncertainty and volatility.

SCAP: Supervisory Capital Assessment Program

The SCAP took the largest 19 banks through a stress test and the results were released publicly. Any banks that were found to have less-than-adequate capital and were unable to raise it themselves would be provided capital via the Capital Assistance Program (CAP). The public disclosure was an important element of the program and was the genesis of today’s annual Federal Reserve stress tests. Ultimately, the credibility of the exercise as well as the existence of available capital from the Treasury pacified markets and in the end none of the banks needed capital from the CAP. While capital doesn’t appear to be the critical issue underlying today’s crisis, a similar approach focusing on a transparent liquidity stress test with funding available for those banks that are unable to address liquidity needs identified in the test could be considered today. Obviously, unlike the GFC, these new tests would be focused on the mid- and small-sized banks instead of the 19 largest.

A new program to consider… BOSS: Ban on Short Sales

A ban on short sales of financial companies, similar to the actions taken by the SEC and U.K. Financial Conduct Authority (FCA) during the GFC, would also be useful in alleviating the pressure being felt on bank stocks. Some of the significant stock moves we’re seeing in bank stocks appear to be detached from underlying fundamentals. Unfortunately, when we’re dealing with financial stocks, sentiment matters and extremely negative sentiment can contribute to a “run on the bank”. Therefore this concept, to ban short selling in financials, is important— to help break the cycle.

While stopping a crisis fueled partially by “animal spirits” is undoubtedly a very complex issue, we think U.S. regulators have the tools/acronyms at their disposal to stamp out today’s crisis. They just need to find the toolbox and put them to work.

Source: FDIC: Temporary Liquidity Guarantee Program; SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Press Release No. 2008-211); Lessons from the Crisis Stress Tests - Federal Reserve Board; Lessons from the Crisis Stress Tests - Federal Reserve Board

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